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Larry A. Oday

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Short Tendering Rule In The Sale Of Securities

*Larry A. Oday**

RULE 10b-4 OF THE SECURITIES AND EXCHANGE Commission, also known as "the short tendering rule," might be described as one of the best kept secrets in securities regulation. Although it has been in effect for more than three years, very few attorneys or brokers know anything about it or have even heard of it.

A short tender is an offer to sell more stock than one owns. The *short tendering rule* prohibits short tenders in response to a tender offer. Typically, a tender offer states the total number of shares to be purchased and also reserves the right to accept by lot; on a first-come, first-served basis; or pro rata in case of oversubscription. The abuse which the short tendering rule was designed to prevent occurs when acceptance in case of oversubscription is to be pro rata. To make the tender offer attractive, particularly in takeover attempts, the price to be paid for the stock is set well above the market. Before the adoption of the short tendering rule, broker A could offer to sell more shares than he owned, taking the risk that should his entire offer be accepted he could purchase needed covering shares in the market at a lower price. In addition, offering more shares than he in fact owned made more likely that those shares he in fact owned would be accepted pro rata. This worked to the detriment of seller B who offered to sell only the number of shares he actually owned by increasing the chances of oversubscription and concomittant activation of pro rata acceptance. In such a situation seller B might find that only 400 of his 500 shares were bought and that he remained the unwilling owner of 100 shares (which ownership may afford him very little control over the affairs of the corporation), whereas had broker A not short tendered, seller A could have sold all 500 of his shares at a price inflated for their control value.

Historical Background

The rule grew out of the 1967 Senate hearings on the Williams amendments. The Banking and Currency Committee of the Senate made the following comments:

At the hearings, the committee was informed of a practice known as short tendering in which brokers tender securities *they do not own*. Tender offers commonly provide that the stock certificates need not be deposited if a bank or a member firm of a stock exchange guarantees that the certificates will be delivered on demand or at a specified time if they are accepted. This procedure was originally introduced to permit acceptance on behalf

*B.A. Case Western Reserve University; Third-year student, Cleveland State University College of Law.

of shareholders who were out of town or otherwise not in a position to deposit their certificates. It has, however, resulted in abuses. For example, if a broker estimates that *only half of the shares* tendered will be accepted, on a *pro rata basis*, he can tender without depositing, twice as many shares as he owns. As a result, all of the shares which he actually owns will be accepted, and the number of shares purchased from other investors will be correspondingly reduced.¹ (emphasis supplied)

It is important to bear in mind that this was part of the Committee's report on the Williams Amendments dealing with *full disclosure* of equity ownership of securities in connection with tender offers. The Senate committee concluded its remarks on short tendering by serving notice to the Securities and Exchange Commission to act:

The committee believes the Securities and Exchange Commission at present has adequate power to deal with the abuse of short tendering under the antifraud provisions of the Securities Exchange Act.²

Shortly thereafter the Securities and Exchange Commission served notice of its proposal to adopt rule 10b-4.

As proposed in January, 1968, the rule defined as a "manipulative or deceptive device or contrivance", as such terms are used in the Securities Exchange Act of 1934, for someone other than the owner of the securities to tender or give a guarantee of tender on behalf of another, unless the guarantor acting in good faith believes that the other person owns the tendered security and will make delivery of the security.⁴ Thus, from the beginning, the Securities and Exchange Commission was willing to make an exception for brokers and banks to guarantee delivery of shares actually owned by customers who are unable to deposit their securities before the termination of the tender offer.

The proposed rule also set forth criteria for determining ownership of a tendered security. One would be considered the owner if:

- 1) He or his agent has title to it;
- 2) He has entered into an unconditional binding contract for the purchase of it even though he has not received it;
- 3) He owns a security convertible into or exchangeable for the tendered security and has transmitted such security for conversion or exchange;
- 4) He has an option to purchase and has exercised the option;
- 5) He has rights or warrants to subscribe for such securities and has exercised such rights or warrants.⁵

The final qualification is that a person is deemed to own a security only to the extent that he has a net long position.⁶ In short, these

¹ S. Rep. No. 500, 90th Cong., 1st Sess. 5 (1967).

² *Id.*

³ SEC, Securities Exchange Act Release No. 8224 (January 3, 1968).

⁴ *Id.* at 2.

⁵ *Id.* at 3.

⁶ *Id.*

are the same standards that apply to rule 10a-1 dealing with short sales.⁷

The January release ended with an invitation to all interested persons to submit views and comments on the proposal. Five months later the Securities and Exchange Commission announced the adoption of the rule.⁸

The Commission did not add a great deal more to its comments in the May, 1968, release, but it did clarify a few questions. First, the rule acts to prohibit short tendering *only* in connection with a tender offer or request or invitations for tenders of a security.⁹ Thus the rule is not applicable unless an offer for tenders has preceded the short tendering. Second, the rule applies to both cash for stock and stock for stock transactions, the latter being known as an ex-

⁷ *Id.*

⁸ SEC, Securities Exchange Act Release No. 8321 (May 28, 1968).

The rule as it was adopted, and as it remains today, reads as follows:
Rule 10b-4. Short tendering of Securities.

(a) It shall constitute a 'manipulative or deceptive device or contrivance' as used in Section 10(b) of the Act for any person, in response to an offer for, or to a request or invitation for tenders of, any security,

- (1) to tender any security for his own account unless (A) he owns the security or, (B) he owns a security convertible into or exchangeable for, or owns an option, warrant or right to purchase the tendered security, intends to acquire the tendered security, by conversion exchange, or exercise of such option, warrant or right to the extent necessary to deliver the tendered security, and upon the acceptance of his tender, he does convert, exchange, or exercise such option, or right to the extent necessary to deliver the tendered security, *Provided, however*, that if he tenders a security on the basis of his ownership of an option to purchase such security, he shall have reason to believe that the maker or writer of the option has title to and possession of such security and will promptly deliver it upon exercise of the option; or,
- (2) to tender or guarantee the tender of any security on behalf of another person, unless (A) such security is in the possession of the person making the tender or giving the guarantee, or (B) the person making the tender or giving the guarantee, upon information furnished by the person on whose behalf the tender or guarantee is made, has reason to believe that such person owns the security tendered and, as soon as possible, without undue inconvenience or expense, will deliver the security for the purpose of the tender to the person making the tender or giving the guarantee, or (C) the person on whose behalf the tender or guarantee is made owns a security convertible into, or exchangeable for, or owns an option, warrant or right to purchase the tendered security and the person making the tender has reason to believe that such other person intends to acquire the tendered security, by the conversion, exchange, or exercise of such option, or right to the extent necessary to deliver the tendered security. *Provided, however*, that if the tender or guarantee of the tender of a security is made on the basis of the ownership of an option to purchase such security, the person making the tender or guarantee shall have reason to believe that the maker or writer of the option has title to and possession of such security and will promptly deliver it upon exercise of the option.

(b) For the purposes of this Rule, a person shall be deemed to own a security if (1) he or his agent has title to it; or (2) he has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it; or (3) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) he has an option to purchase or acquire it and has exercised such option; or (5) he has rights or warrants to subscribe to it and has exercised such rights or warrants. *Provided, however*, that a person shall be deemed to own securities only to the extent that he has a net long position in such securities.

⁹ *Id.*

change offer.¹⁰ Third, and most importantly for brokers, although the rule prohibits short tendering, it still is possible for a broker or a bank to guarantee delivery for customers who own the tendered securities, but who are unable to deposit their securities before the termination of the tender offer.¹¹ Finally, the Commission cited sections 10(b) and 23(a) of the Securities Exchange Act as the statutory basis for promulgating the Rule.¹²

The rule was adopted and went into effect July 1, 1968. Now, over three years later, it sits there, waiting for its first court action enforcement by the Securities and Exchange Commission.

Fraud Requirements and the Bache Case

The rule makes short tendering a "manipulative or deceptive device or contrivance" as such terms are used in section 10(b) of the 1934 Act. What does this mean? Do the fraud requirements of the other 10(b) rules apply to 10b-4? Let us look first at the general meaning of fraud as used in the securities acts.

It is well settled that the type of "fraud" required to establish a violation of the acts is less than the requirements at common law.¹³ The intent seems to be that the securities acts in general, and section 10(b) of the 1934 Act in particular, are to be interpreted broadly¹⁴ so as to effectuate the remedial purposes of the legislation.¹⁵ Thus it would seem that the liberal interpretation would apply to the short tender rule as well, but there are disturbing rumblings to the contrary on the basis of the *Bache* case.¹⁶

In *Bache*, a broker was suing the tender offeror for failure to accept all the shares tendered before the offer terminated. The defendant raised, inter alia, rule 10b-4 as a defense, on the grounds that the plaintiff had erroneously short tendered 148 shares out of a total of 30,649. The error was the result of a duplication in orders and was corrected immediately upon discovery the next day. As a result the court disallowed the defense. In so doing, the court held that the rule does not apply where there is such a small percentage of shares short tendered and where there is no evidence of a specific intent to defraud. Further, it was held that the manipulation must be of the normal *pro rata* requirements of the tender offer.¹⁷

Potentially, this decision raises more problems than it solves. It would certainly seem that the case runs counter to the spirit of other

¹⁰ *Id.*

¹¹ *Id.* at 2.

¹² *Id.*

¹³ *Lerman v. Tenney*, 295 F. Supp. 780 (S.D.N.Y. 1969).

¹⁴ *Securities and Exchange Comm'n v. Gulf Internat'l Finance Corp.*, 223 F. Supp. 987 (S.D. Fla. 1963).

¹⁵ *Carroll v. First Nat'l Bank of Lincolnwood*, 413 F. 2d 353 (7th Cir. 1969).

¹⁶ *Bache & Co. v. International Controls Corp.*, 324 F. Supp. 998 (S.D.N.Y. 1971).

¹⁷ *Id.*

court decisions that section 10(b) should be interpreted broadly so as to effectuate the remedial purposes of the legislation.

First, the court held that a short tendering of 148 shares out of 30,649 was not sufficient to bring it within the purview of the rule. The question then arises—what would have been enough shares? Would 1,000 have been a significant number? Would the result have been different in *Bache* if the 148 shares had been the difference between control and non-control or if the tender-offeror had relied, to his detriment, on those 148 shares? In any case, the rule itself does not prohibit the short tendering of a “significant number of securities,” but prohibits it for “*ANY SECURITY*.”

The court's second holding that a mere mistake will not invoke the rule, seems to indicate that scienter is a requirement in order to establish fraud in securities act cases. Yet there are many cases to the contrary.¹⁸ This contrary view is consonant with the general rule that the requirements of proof to find fraud in securities cases are not as stringent as are the requirements of the common law.

The court's third holding was that there must be a specific intent to defraud. An act of mere negligence was not enough. Yet the courts have held in other areas of the securities statutes that such intent is not necessary. For example, it has been held unnecessary to show a specific intent to defraud in order to prove a violation of section 14(e) of the 1934 Act.¹⁹

One should, therefore, not be guilty of reading too much into the *Bache* case. The holding is really very limited and is probably correct as it is applied to the specific facts in that case. Indeed, one can argue that *Bache* is a very good example of self-compliance with the rule.

Possibilities for Civil Litigation

The question remains as to what application the rule has for the securities specialist. Specifically, what potential does rule 10b-4 have in court? Certainly it has been of very little value to date since not even the Securities and Exchange Commission has made use of the rule. In a letter to the author, the Commission stated that it was not aware of any enforcement action, either legal or equitable, that it has taken against any violator of the rule.²⁰ It is clear, however, that the Commission would sue for injunction if the need should arise. In this respect, the enforcement of the rule is the same as any of the other rules under section 10(b). However, to date the rule has re-

¹⁸ *Ellis v. Carter*, 291 F. 2d 270 (9th Cir. 1961); *Texas Continental Life Ins. Co. v. Dunne*, 307 F. 2d 242 (6th Cir. 1962); *Kohler v. Kohler Co.*, 319 F. 2d 634 (7th Cir. 1963).

¹⁹ *Butler Aviation Internat'l, Inc. v. Comprehensive Designers, Inc.*, 307 F. Supp. 910 (S.D.N.Y. 1969).

²⁰ Letter from Ezra Weiss, Chief Counsel, Division of Trading and Markets of Securities and Exchange Commission by Albert D. Sturtevant, Attorney, to Larry A. Oday, dated August 20, 1971.

mained an unused tool by the Securities and Exchange Commission. One can only speculate as to why this is so. Two answers come immediately to mind. The first possible answer is that brokers stopped short tendering when the rule was promulgated. The second possibility is that the Commission has not bothered to enforce infractions of the rule. Undoubtedly, neither of these is the whole answer, but both are probably true to some extent.

Nevertheless, the mere fact that the Securities and Exchange Commission has seen no necessity to bring action based upon the rule is no reason for the attorney who is embroiled in civil litigation over a takeover bid to ignore its possibilities. Clearly the attorney for the defendant did not in the *Bache* case. Indeed, one of the significant results of that case is that the court impliedly allowed the rule to be a potential defense. The court did not say that the rule per se was not a defense, but only that under the particular facts of that case, rule 10b-4 was not applicable as a defense.²¹ Obviously then, the rule can be used for the benefit of the tender offeror who has suffered as a result of the short tendering of a broker or stockholder in civil litigation.

However, it is for another potential plaintiff that the rule remains a great untapped resource. This is the target corporation of the tender offer, or, in a derivative suit, the shareholder in same. In this respect rule 10b-4 can be used as rule 14a-9 was in *J.I. Case Co. v. Borak*.²² That case upheld the right of shareholders to sue in the appropriate federal district court to enforce any liability or duty created under section 27 of the Securities Exchange Act.²³ The object in *Borak* was dissolution of a merger. The purpose would be the same in a suit for the target corporation or shareholder using rule 10b-4. In the first instance there was a violation of the proxy rules, and in the second it would be short tendering. The two are analagous in the sense that what the Commission is seeking is *disclosure*—full and complete disclosure. As was noted earlier rule 10b-4 was an outgrowth of the Williams amendments. Those amendments were aimed at disclosure by the parties involved in tender offers, principally the offeror. A principal reason for the passage of those amendments was to prevent a person from accomplishing through a tender offer what he had not been able to accomplish with a proxy fight. Now with both, disclosure is required. A short tender is a kind of non-disclosure. It would seem that that is why the Commission made short tendering a “manipulative and deceptive device or contrivance.” Thus should a broker short tender, the target corporation can use this transgression by the broker to void the deal and keep the corporate raider-tender offeror from taking over.

²¹ *Bache & Co. v. International Control Corp.*, 324 F. Supp. 998 (S.D.N.Y. 1971).

²² *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964).

²³ *Id.*

Conclusion

A philosophy which could justifiably be adopted in regard to rule 10b-4 is that the professional broker should be stopped from using his superior knowledge of the relative success of a particular tender offer without disclosure. Bearing that in mind, it is perhaps not so extraordinary that so few brokers have knowledge of the rule—and for those that do the knowledge is limited. (The author personally spoke with ten executives of brokerage houses in Cleveland. Not a single one was familiar enough with the rule to comment on it.)

It is also, perhaps, not so extraordinary that there are no reported cases of Security and Exchange Commission enforcement action or action between civil litigants. The explanation for this is, hopefully, that the brokers are complying with the rule.

So rule 10b-4 remains in virtual oblivion. Nevertheless, it can be a very valuable tool to force full disclosure in tender offers. The rule also has enormous potential for civil litigation where the target corporation is interested in resisting the takeover bid of the corporate raider. Only time will tell whether this full potential will be tapped or whether the rule will fade even further into oblivion.